TREASURY - GENERAL

STATE INVESTMENT COUNCIL
Private Equity

Proposed New Rules: N.J.A.C. 17:16-90

Authorized By: State Investment Council, Peter A. Langerman, Director, Division of Investment

Authority: N.J.S.A. 52:18A-91

Calendar Reference: See Summary below for explanation of exception to calendar requirement.

Proposal Number: PRN 2005-70

Submit comments by April 23, 2005 to:

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The agency proposal follows:

Summary

The proposed new rules establish private equity as an investable asset class for five New Jersey pension funds (Police and Firemen's Retirement System; Public Employees' Retirement System; State Police Retirement System; Teachers' Pension and Annuity Fund; and Judicial Retirement System of New Jersey) under management by the Division of Investment. Private equity, as defined in the proposed new rules, means investments in businesses made through means other than through publicly-traded securities and may consist of buyout funds (investing in the acquisition of a company); venture capital funds (investing in the equity of a small, privately-owned, high-growth company during its early stages); and debt-related investments. The assets of the eligible

pension and annuity group funds could be invested in the following way: separate account (ownership is segregated and kept in the investor's name), fund-of-funds (a fund set up to distribute investments among a selection of fund managers, who in turn invest the capital directly), limited partnership (legal entity formed for the purpose of investing in private equity funds; the partnership is generally comprised of one general partner and multiple limited partners; this type of fund has a fixed life, which is usually 10 years); direct investment (the purchase of an interest in a company or venture that has enough influence to direct the course of the investment; this type of investment usually avoids intermediaries between the buyer and the seller); and joint venture (contractual agreement joining two or more parties for the purpose of executing a particular undertaking; all parties agree to share in the profits and losses of the enterprise). The pension funds' commingled shares of private equity would be held in the newly proposed Common Pension Fund E, which is the common fund to be established by N.J.A.C. 17:16-69, proposed elsewhere in this issue of the New Jersey Register.

For any of the pension and annuity group funds investing in Common Pension Fund E, certain limits will apply for each of the following subcategories – buyout investments (no more than 3.75 percent of the market value of any pension fund's assets may be invested in this subcategory); venture capital investments (no more than 1.75 percent of the market value of any pension fund's assets may be invested in this subcategory); and debt-related investments (no more than 1.75 percent of the market value of any pension fund's assets may be invested in this subcategory). No more than 2.45 percent of the market value of the assets of any pension and annuity group fund investing in Common Pension Fund E may be invested outside the United States.

An overall aggregate market value limitation on private equity investments is set at seven percent of the market value of all assets of any of the eligible pension funds investing in Common Pension Fund E, and the State Investment Council shall be notified at a regularly scheduled meeting if the market value exceeds seven percent; however, the Division may be granted a six-month grace period in which to reduce the level of participation below the seven percent level, with an allowance for additional four-month extensions, as approved by the State Investment Council.

Because the Division is providing a 60-day comment period on this notice of proposal, this notice is exempt from the rulemaking calendar requirement pursuant to N.J.A.C. 1:30-3.3(a)5.

Social Impact

The proposed new rules are intended to expand the asset classes in which the State's pension funds can be invested and it is not anticipated that any actual social impact from the proposed new rules will occur.

Economic Impact

The proposed new rules will facilitate investment diversification, which based upon historical experience, should result in a reduction of total portfolio risk for the State's pension funds while offering an opportunity for improved rates of return over time. Therefore, it is not anticipated that the rules will have a negative economic impact; rather, the potential for improved returns should bode favorably for the State's taxpayers by reducing the level of State and municipal contributions over the long term.

Federal Standards Statement

A Federal standards analysis is not required because the investment policy rules of the Division of Investment are under the auspices of the State Investment Council, and are not subject to any Federal requirements or standards.

Jobs Impact

The State Investment Council and the Division of Investment do not believe that any jobs will be lost by virtue of the proposed new rules. Rather, the expectation is that there will be a creation of jobs within the Division of Investment to assist with the implementation and monitoring of this proposed investment program.

Agriculture Industry Impact

The proposed new rules shall have no impact on the agriculture industry.

Regulatory Flexibility Statement

A regulatory flexibility analysis is not required, since the proposed new rules impose no requirements on small businesses as the term is defined in N.J.S.A. 52:14B-16 et seq., but regulate only the Director of the Division of Investment.

Smart Growth Impact

The proposed new rules are not anticipated to have an impact on the achievement of smart growth and implementation of the State Develoment and Redevelopment Plan.

Full text of the proposed new rules follows:

SUBCHAPTER 90. PRIVATE EQUITY

17:16-90.1 Definitions

The following words and terms, as used in this subchapter, shall have the following meanings, unless the context clearly indicates otherwise:

"Buy-out fund" means a fund that invests in the acquisition of an established company. The transaction may or may not be leveraged.

"Co-investment" means two parties (usually the limited partner and the general partner of a fund) invest alongside each other in the same company. If a limited partner in a fund has co-investment rights, it can invest directly in a company that is also backed by a fund. The institution therefore ends up with two separate stakes in the company - one indirectly through the fund; one directly in the company.

"Direct investment" means the purchase of an interest in a company or venture that has enough influence to direct the course of the investment. Direct investment usually avoids intermediaries between the buyer and the seller.

"Funds-of-funds" means funds set up to distribute investments among a selection of fund managers, who in turn invest the capital directly.

"Joint venture" means a contractual agreement joining two or more parties for the purpose of executing a particular undertaking. All parties agree to share in the profits and losses of the enterprise. Joint ventures are usually private.

"Limited partnership" means the legal entity formed for the purpose of investing in private equity funds. The partnership is generally comprised of one general partner and multiple limited partners. A limited partnership has a fixed life, usually of ten years.

"Private equity" means investments in businesses made through means other than through publicly traded securities. Private equity may consist of buyout funds, venture capital funds and debt-related investments.

"Separate account" means ownership is segregated and kept in the investor's name.

"Venture capital fund" means a fund that invests in the equity of a small, privately-owned, high-growth company during its early or expansion stages.

17:16-90.2 Permissible investments

(a) Subject to the limitations contained in this subchapter, the Director may invest in private equity through separate accounts, funds-of-funds, limited partnerships, direct investments, co-investments and joint ventures in any of the following ways:

1. Buyout Investments: Purchase of a control position (primarily majority positions, with some minority positions) in established companies, with or without leverage, is permissible provided:

   i. No more than 3.75 percent of the market value of the assets of any pension and annuity group fund investing in Common Fund E may be invested in this subcategory; and

   ii. No more than 2.45 percent of the market value of the assets of any pension and annuity group fund investing in Common Fund E may be invested outside of the United States.

2. Venture Capital Investments: Purchase of an equity position in small, privately-owned, high-growth companies is permissible provided:

   i. No more than 1.75 percent of the market value of the assets of any pension and annuity group fund investing in Common Fund E may be invested in this subcategory; and

   ii. No more than 2.45 percent of the market value of the assets of any pension and annuity group fund investing in Common Fund E may be invested outside of the United States.

3. Debt-related Investments: Purchase of investments which combine a debt instrument with equity participation is permissible provided:

   i. No more than 1.75 percent of the market value of the assets of any pension and annuity group fund investing in Common Fund E may be invested in this subcategory; and

   ii. No more than 2.45 percent of the market value of the assets of any pension and annuity group fund investing in Common Fund E may be invested outside of the United States.

17:16-90.3 Applicable funds

(a) Applicable funds are as follows:

1. Police and Firemen's Retirement System;
2. Public Employees' Retirement System;
3. State Police Retirement System;
4. Teachers' Pension and Annuity Fund; and
5. Judicial Retirement System of New Jersey.

17:16-90.4 Limitations

(a) The aggregate market value of private equity investments under this subchapter, for any eligible pension fund, shall not exceed seven percent of the market value of all assets of such pension fund.

(b) If the market value exceeds seven percent, then the State Investment Council shall be notified at a regularly scheduled meeting of the Council. The Division may be granted a six-month period of grace to reduce the level of participation of the fund below the seven percent level, except that the period of grace may be extended for additional four-month periods with the approval of the Council.

17:16-90.5 Legal papers

(a) Prior to any commitment to purchase obligations of the type described in this subchapter, the Director shall have obtained:

1. A prospectus or offering documentation describing the investment;

2. A purchase agreement, if applicable; and

3. Such other documents or opinions which the Attorney General may require.